THE ROLE OF THE BANK DIRECTOR IN "INTERESTING TIMES"

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I appreciate the opportunity extended to me by Thad Woodard and the NCBA to speak with you today. Since assuming the office of Commissioner of Banks last summer, I have been particularly impressed by the quality of directors attending our Directors College and their commitment to their institutions and communities. This Assembly is a valuable compliment to the Directors College, and I applaud you for attending. You are going to hear from a number of highly qualified speakers on current issues confronting bank directors. Rather than "front run" what you will hear for the rest of the Assembly, I will try to augment it from my perspective as a former bank General Counsel and as Commissioner of Banks.

I am told that there is an ancient Chinese curse as follows: "May you live in interesting times." Bank directors will be forgiven for believing that the curse applies to them. These are, indeed, interesting times for bank directors. The ills, both real and imagined, that afflict American corporate governance and the legal and regulatory responses to them have made directorship of a banking organization a more "interesting" proposition than in times past and a more risky one. Understanding and dealing with the topics that will be reviewed at this Assembly is necessary to your success as directors but not, in my opinion, sufficient. I would like to discuss with you several other broader topics for your consideration.

<u>Board Diversity</u>

In the post-Enron world, corporate governance will be an issue of importance for the foreseeable future. While that is a good thing, I believe it creates its own potential hazards. I am concerned that boards will be so focused on meeting the growing and specific requirements of law and custom – independence, expertise, etc. – that they will not concern themselves enough with whom exactly the members are and how they interact. I believe it will be crucial for future boards to be truly diverse in terms both of background and habits of mind.

It is commonplace to discuss diversity in terms of race and gender. These issues of board composition are important, given the likely development of the marketplace in the future. A recent study by Harvard University's Joint Center for Housing Studies points out some interesting demographic trends that will affect the housing market in the future, but that will almost certainly affect financial services as well. The study points out that:

> Over the next 20 years, the number of U.S. households will likely increase 22.6 percent to 129 million. Minorities will account for almost two-thirds of this growth, climbing 59 percent to over 41 million households. At the same time, the number of non-family households will most likely rise by 9.4 million (28 percent). By 2020, the 43 million non-family households will thus make up a third of all households.
>
> These changes in the race, ethnicity, and family structure of households will substantially alter the characteristics of homeowners. After dominating the homebuyer market throughout the postwar period, white families will account for less than 30 percent of the 22.2 million net new homeowners added by 2020. The number of minority

> homeowners will increase by 10.4 million to 22.5 million over this period, lifting the minority share of all owners to 24 percent…. Non-family homeowners will also increase in number by 7.8 million, or 45 percent.[1]

The Harvard study at least strongly suggests that board diversity is more than just "politically correct"; properly done, it is good business. This conclusion would probably be reinforced in the case of most banking organizations by a cursory review of the demographics of the firm's work force.

Demographic diversity is not the only form of board diversity you may wish to consider. A recent study by researchers at the University of Bath, England, suggests that diversity of skills, more in the sense of executive style than professional specialty, is also important.[2] The Bath researchers discuss four types of "non-executive" directors, three of which are desirable, one of which is not:

> Tame pensioners are the stereotypical rubber stamp directors. Every board, like every family, has one or more. Removing such directors or surrounding them with competent colleagues is a crucial task of corporate governance.

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[1] Joint Center for Housing Studies of Harvard University, "The State of the Nation's Housing 2002", p. 12 at http://www.jchs.harvard.edu/publications/markets/Son2002.pdf.

[2] Pye and Camm, "Take on Board the Necessary Skills," Financial Times (January 17, 2003) p. 7.

Auditor-type directors bring “a ruthless view of the world outside” to the board and view management’s bright ideas with a skeptical eye from a risk management perspective.

Consultant-type directors, on the other hand, bring skills to the company that it did not have before, work with management in the development of strategy, and have a coaching and developmental relationship with management.

Finally, the super non-executive director is something of a hybrid of the two preceding types, combining strategic and risk management perspectives and mediating between auditor and consultant-type colleagues.

The conclusions of the Bath research are that tame pensioners need to go and that boards need a combination of the remaining types, with the mix of skill sets depending on the corporation’s circumstances. Interestingly, the researchers suggest that different types of directors require different types of compensation: cash compensation for auditor types, equity for consultants and a combination for “super NEDs.” Following best practices in this country, the Bath researchers suggest that directors subject themselves to performance evaluations comparable to their evaluations of management personnel.

Each of the diversity suggestions that I have just discussed may be a little advanced for your banking organizations, particularly relatively new ones. My request to you is that you think about them and discuss them. As your institutions grow and change, I think you would be well served to give them a second look.

<u>The Customer Relationship</u>

A second issue that you should confront in these interesting times is the relationship your institution has with its customers. This may seem an odd topic to discuss with directors of banking organizations generally and community institutions in particular. Surely you and your management know your customers better than anyone else. What could require a reconsideration of your relationship with them? Let me suggest a few aspects of our "interesting" world that require such reconsideration: security issues after September 11; the never-ending search for fee income; and consumer privacy concerns.

<u>"Know your customer" after September 11</u>.

As you very well know, the events of "9/11" materially changed our world. Among such changes is a heightened concern regarding security from terrorism that affects many aspects of our lives, including financial services. People of good will can differ about the particulars of the Bank Secrecy Act and the USA PATRIOT ACT; however, bank directors should understand that their regulators and law enforcement officials are of one mind about enforcing them. Understanding of these statutes and related regulatory interpretations, particularly with regard to the "know your customer" issue, is crucial for bank directors. These laws will have an impact on your relationship with your customers if you obey them, so a review with your management about how you are going to comply is crucial.

Fee Income and Customer Relations.

It is a commonplace in the banking industry that non-interest income is a good thing. Interest rate movements have been a very "interesting" feature of the business in the recent past and reducing your institution's dependence on the spread is a worthy goal. Non-interest income can be generated in a number of ways, however; and what your institution chooses to do to generate it affects your relationship with customers profoundly. As an interested observer of your conduct in this regard, I would like to suggest to you that, at the margin, more effort should be applied to meeting the needs of customers for financial security and less to the creation of usage fees for traditional services. Let me explain.

Consumers today need advice and assistance in strengthening their personal balance sheets. The recent unpleasantness in the stock market (which according to Federal Reserve Governor Ben Bernanke has led to "the wry joke that our 401(k)'s are now 201(k)'s!"[3]) has reduced the assets available to many people for retirement and other future needs and may have discouraged your customers from reassessing their future needs and taking the necessary corrective steps, such as saving more and reallocating their investments. Governor Bernanke, a distinguished economist, is generally

[3] The Federal Reserve Board, Remarks by Governor Ben S. Bernanke at the 41st Annual Winter Institute, St. Cloud State University, St. Cloud, Minnesota, February 21, 2003: The Balance Sheet and Recovery, found at http://www.federalreserve.gov/boarddocs/speeches/2003/20030221/default.htm (downloaded February 25, 2003), p. 3.

sanguine about current levels of consumer debt, more so than Commissioner Smith; however, he gives persuasive evidence that the increase in consumer indebtedness in recent times reflects a generally healthy restructuring of consumer balance sheets with attendant beneficial effect on the economy.[4] I believe he and I would agree that this restructuring requires a careful assessment of the consumer's debt capacity and discipline to prevent home mortgage financing from becoming the engine for consumer debt overload. Finally, it is probable that consumers are underinsured, which circumstance can have devastating effects on their well being.[5] All of the foregoing circumstances present banking organizations with the opportunity to generate non-interest income in ways that increase consumer welfare.

There is, of course, a second source of non-interest income to banking organizations: service charges. These charges have long been a feature of retail banking and arguably have helped to finance the expansion of retail banking services. That having been said, the number and amount of such fees and charges have been increasing in recent years and have been significantly increased by so-called "bounce protection programs." These programs are not cost- or risk-free; and given their increasing presence in North Carolina, I think it important to make clear the concerns that I believe you as directors should have about them. Specifically:

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[4] *Ibid,* pp. 3-5.
[5] *See, e.g.,* White, "What Will It Take for Bank Insurance to Succeed in the United States?" 2 NC Banking Inst. 123 (1998).

- None of these programs has been approved in any way by the Office of Commissioner of Banks or, to my knowledge, any other regulator.

- These programs are the subject of increasing attention by federal and state regulators and consumer advocates throughout the country.

- These programs bring with them regulatory, reputation and litigation risk that should be carefully assessed before they are implemented and monitored thereafter.

- To my knowledge, no bounce protection programs were included in the business plans of recently formed North Carolina banking organizations; and, in the case of community institutions generally, it is difficult to see how such programs are consistent with the "friendly home town bank" image that many community bankers tell me they are pursuing.

I realize that, to paraphrase an old joke, I may have ceased preachin' and started meddlin'; however, I don't see how, as a friend of the industry, I can fail to comment on the issues raised by these programs. The customer relationship we are discussing depends ultimately on the customer's trust in you. It is hard for me to see how competent directors can ignore the potential impact of service charges on this trust and the potential implications of its loss.

Privacy: the issue that won't go away.

Finally, how your institution handles the privacy concerns of its customers will have a substantial impact on its relationship with them. The concerns that fostered the Gramm-Leach-Bliley Act privacy provisions are still with us and are complicated by the security issue discussed above and by non-interest income concerns to the extent that cross-selling involves either referral to an affiliated company or to a third party service provider. My personal experience in banking is that, next to money itself, people are most "interesting" about their privacy. I am not telling you not to cross-sell or share information in an appropriate (legal) way. I am telling you that doing so requires clear communication with customers, including an explanation of the value customers get from information sharing.

In spite of all the red flags mentioned above, I believe that security, non-interest income and privacy concerns can all be addressed successfully without compromising a bank's franchise or business prospects. A bank's directors can and should facilitate this result by: (i) understanding how the institution is addressing each issue; (ii) insuring that the institution's policies on these matters are consistent with its business strategy and publicly stated values; (iii) requiring management to explain how each issue is being addressed, including a discussion of relevant risks; and (iv) insuring that the institution negotiates relationships with its customers that are based on full, fair and clear disclosure and a perceived exchange of value that is fair. This isn't easy, but who said being a director was easy?

In closing, I would like to return to the Chinese *motif* with which we began. It is interesting to note that one-half of the Chinese character for "disaster" denotes "opportunity." I believe that this fact is at least metaphorically relevant to our discussion today. With proper thought and action, the "interesting" circumstances in which all of us find ourselves these days can be made rewarding in personal, community and (yes) financial terms. I hope and intend that our work together in the future will lead to that result.

Thank you for your attention.